IN THE

Supreme Court of the United States

No. .....

ADVANCE MACHINERY EXCHANGE, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner respectfully prays that a writ of certiorari issue to review the decision and judgment of the instant case—the *Advance Machinery Exchange, Inc.*—of the United States Court of Appeals for the Second Circuit, both dated May 12, 1952. Requisite copies of the transcript of the record of this case in the Tax Court of the United States and the decision of the United States Court of Appeals for the Second Court are furnished herewith in accordance with Rule 38.

Jurisdiction.

The statutes under which jurisdiction is invoked are Title 28, United States Code, Sections 1254 and 2101, and Title 26, United States Code, Section 1141.

Summary Statement of the Matter Involved.

The Supreme Court of the United States is asked to review the decision and judgment of the United States Court of Appeals for the Second Circuit in *Advance Machinery Exchange, Inc.* v. *Commissioner,* No. 83, May 12, 1952 (52-1 U. S. T. C. Para. 66,036), which affirmed the previous Memorandum Decision of the Tax Court of the United States, 8 T. C. M. 84, C C H Dec. 16,812 (M).

The Second Circuit Court telescoped all the 1942 income of three corporations and one sole proprietorship for income and excess profits taxes into one of the corporations, i.e., the petitioner. It further held that this petitioner-corporation was not entitled to use the equity invested capital of the other entities for excess profits tax computation despite the allocation of all the group income into the petitioner-corporation for both federal taxes.

The Second Circuit Court arrived at this inconsistent conclusion by invoking Sections 45 and 718 of the Internal Revenue Code (See Appendix). The Tax Court had earlier achieved the same unreasonable result by the use of Sections 22(a) and 718 of the Internal Revenue Code (See Appendix).

The Commissioner of Internal Revenue urged the application of all these statutes. Notwithstanding the statement to the contrary in the decision of the Second Circuit Court, the petitioner respectfully submits that the Tax Court ruled out Section 45 and decided against the petitioner on the basis of Sections 22(a) and 718.

The Third Circuit Court in the recent similar case, *Chelsea Products* (C. C. A.-3, Nos. 10652, 10653, June

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For the sake of clarity and expedition, we employ only the marginal paragraph numbers which run consecutively through the Transcript of Record on petition to review the decision of the Tax Court of the United States. To also use the numbers within the body of this Transcript would only cause confusion.

24, 1952) has already found occasion to criticize the Second Circuit Court's decision in the case at bar. This sister-Circuit Court holds that the Second Circuit Court should have affirmed the decision of the Tax Court not under Section 45 but under the same statutes that the Tax Court used, namely, Section 22(a) as well as Section 718. Obviously, the Second and Third Circuit Courts are in conflict as to the propriety of the statute to apply to the facts in the instant case.

The Third Circuit Court had this to say in part:

> "In affirming the decision of the Tax Court, the Court of Appeals for the Second Circuit (in Advance Machinuery Exchange, Inc.) relied on Section 45 rather than Section 22(a). We consider the Court's observation with respect to Section 45 to be essentially dicta, for, since the Tax Court had determined that there was but one taxable entity, all the net income was necessarily taxable to taxpayer under Section 22(a)." Words in parentheses supplied.

Section 22(a).

Section 22(a) merely defines Gross Income (See Appendix). This statute could not possibly be involved in the instant case. The issue before us is: Whose income is it? and not What is taxable income? The statute that defines taxpayer, which is the crux of our problem, is Section 3797. This long statute defines "Person," "Partnership and Partner," "Corporation" • • • "Taxpayer" etc. etc.

It is admitted that judge-made law has amplified the interpretation of Section 22(a). The petitioner hazards the opinion that two tax corollaries have evolved from the court decisions construing Section 22(a). One of them is:

Income is attributable to the one who owns the source of that income, and the fruit on the tree is charged as income to the owner thereof.

The Supreme Court of the United States needs no enlightenment on this doctrine because it has contributed so much to its development. The mere mention of the landmark cases in this regard should be adequate:

Helvering v. *Clifford,* 309 U. S. 331;
Com'r v. *Sunnen,* 333 U. S. 591;
Sewell v. *U. S.,* 73 F. Supp. 957;
Becker v. *Glenn,* 29 F. Supp. 558;
Harrison v. *Schaffner,* 312 U. S. 579;
Helvering v. *Horst,* 311 U. S. 112;
Bardach v. *Com'r,* 90 F. (2d) 323;
Apt v. *Birmingham,* 89 F. Supp. 361;
Court Holding Co. v. *Com'r,* 324 U. S. 331.

The petitioner insists that it never owned or had dominion over the income-producing property that it is alleged to have tried to divert to the other three entities to effect tax economy. Since it did not own such property, it could not have transferred it. Accordingly, Section 22(a) cannot possibly be germane to the issue at hand.

The other tax corollary that evolved from the judge-made law that stems from Section 22(a) holds:

If the subject matter of the sale, transfer or donation is not the source of the income but the income itself (metaphorically, the fruit of the tree), taxation is not escaped.

Here, too, the Supreme Court of the United States is very familiar with this doctrine because of the contributions it made to its evolution. Hence the petitioner merely cites a few leading decision in this regard:

Helvering v. *Eubank,* 311 U. S. 122;
Helvering v. *Horst,* 311 U. S. 112;

Cohen, 15 T. C. 261;
Austin v. *Com'r*, 161 F. (2d) 666;
Strauss v. *Com'r*, 168 F. (2d) 441.

In the light of the facts in the Transcript of Record and in the Tax Court's Findings of Fact it cannot properly be held that the petitioner had the income to commence with in order to divert it to the other three entities.

Metaphorically speaking, the petitioner denies that it had the tree (source of income) or the fruit thereof (income) in the light of the facts to have been able to deflect income to the other three entities within the scope of Section 22(a).

Fundamentally, our issue is not whether certain items are taxable or not. The question is, Are the four entities separate and distinct business vehicles responsible for their own respective tax liabilities, or are their net aggregate net incomes attributable to the petitioner? In other words, the controversy is over Whose income is taxable? and not What is taxable income? The fact that an item constitutes "gross income" does not determine who must pay the tax thereon.

Furthermore, if Section 22(a) is applicable to this situation, then it must follow perforce that not only is the petitioner tax-liable for their aggregate net incomes, but the petitioner's invested capital credit must be the aggregate invested capitals of the four entities to compute normal-earning-return on capital to arrive at, by subtraction, excessive earnings subject to excess profits tax under Section 718 (See Appendix).

The instant case is the first and only time that the Tax Court concurred with the Commissioner in the latter's attempt to apply Section 22(a) where Section 45 cannot be sustained. In *Grenada Industries, Inc.*, 17 T. C. No. 28, the Tax Court in a comparable factual situation suffered a change of heart. It expressly announced that the Com-

missioner cannot do under Section 22(a) what he cannot do under Section 45. It said in part:

> " • • • Thus, to the extent that Section 45 may be applicable, Section 22(a) adds nothing to the strength of respondent's position • • •."

The petitioner humbly urges that though it respects the entire concept of judge-made law in American jurisprudence, the attempt made by the Tax Court in the instant case, is an abuse of such doctrine, and apparently the Third Circuit Court in *Chelsea Products, supra,* concurs in this view. The petitioner prays that, should the Supreme Court of the United States grant certiorari, that it do not reapply Section 22(a) to these facts. Such conduct would constitute a very obvious violation of Congressional intent to merely define gross income. How can two corporations be pierced and the prime-moving human being of all four ventures be destroyed economically and all their incomes be dumped into the lifeless corporate-petitioner by the mere Congressional fiat of a definition of gross income!

Section 45.

But the Second Circuit Court decided the instant case under Section 45 (See Appendix) and not under Section 22(a). The application of Section 45 is just as fallacious as the use of Section 22(a) to the facts of the instant case.

Section 45 was enacted to prevent inter-company manipulations whereby profits and losses are arbitrarily shifted from one business entity to another. In its own language it is applicable in any case of two or more organizations controlled by the same interests, but only if reallocation is necessary to prevent evasion of taxes or to reflect income clearly; and where appropriate, it merely authorizes the Commissioner:

" • • • to distribute, apportion, or allocate gross income • • • between or among such (two or more) organizations • • • " (See Appendix).

In the case at bar, the Second Circuit Court in violation of Section 45 consolidated the net incomes of the four entities into that of the petitioner. Section 45 does not permit consolidations of incomes. It merely allows the reallocation of incomes and losses. By illustration the Commissioner's own Regulations 111, Sec. 29.45-1 (6)(b) specifically (See Appendix) deny the consolidation of the respective incomes of the two or more corporations involved as if they constituted only one business entity.

In the case at bar, Revenue Agent Diehl found alleged alterations of purchase invoices in his samples of about 10% in the petitioner, 50% in another corporation, and 50% in the third corporation (Tr. 950-966). From memory, he says there were few in the case of the petitioner but more in the other two entities. There were twenty-six transactions out of the very many in the year 1942 where the petitioner collected the proceeds and then distributed them to the other three entities, because not the petitioner but one or several of the other three entities sold the merchandise in the first instance (Tr. 912-941, 124, 125).

If Section 45 must be invoked, then the Second Circuit Court should have redistributed, reapportioned and reallocated the various items among the four entities involved to effect their true respective incomes, because there were alleged alterations of purchase invoices in all the entities. Certainly, the Second Circuit Court was legally in error when they consolidated their respective net incomes into the petitioner.

The Second Circuit Court telescoped the incomes of the four entities—three corporations and one sole proprietorship—into one of the corporations. Thus, two and not all three corporate entities were pierced, and to boot

the prime mover of all the four entities, i.e., the human being who conducted the sole proprietorship, was destroyed economically.

The Treasury Regulations 111, Para. 29.45-1 (b) (See Appendix) amplifies the obvious and apparent intent of Congress in its statute Section 45 that the Commissioner may reallocate debits and credits among related business entities of all kinds, and specifically prohibits the consolidation of incomes in the case of related corporations under Section 141 to prevent evasion of taxes or clearly to reflect their respective incomes.

The petitioner willingly admits that the telescoping of all the incomes of several related businesses into one entity may be a proper reallocation of debits and credits in the extreme case of tax fraud. In the instant case, however, the petitioner has not been charged with civil or criminal tax fraud, not even with negligence. Thus, the Second Circuit's pronouncement in its decision about such a theoretical possibility is a complete *obiter dictum*, and is a gratuitous and unwarranted characterization which only misleads and is not pertinent to the facts in the case at bar.

The Third Circuit Court in the *Chelsea Products* case, referred to above (C. C. A.-3, Nos. 10652, 10653, June 24, 1952), in a set of facts similar to those in the instant case, also objected to the telescoping of the four entities by the Second Circuit Court in the petitioner's case and argued that Section 45 prohibits a complete telescoping of the incomes of a number of entities. This is what it had to say in criticism:

> "Section 45 grants to the Commissioner power to allocate gross income, deductions, credits, or allowances. There is no mention of authority to disregard completely the corporate entity by combining the net income of controlled corporations. The plain language of Section 45 must prevail."

The Tax Court decision in the case at bar is the first application of Section 22(a) in a Section 45 fact pattern. The Second Circuit Court decision, affirming the Tax Court in this case at bar, is the first holding under Section 45 that four business enterprises may constitute one taxable entity.

This decision is of great national economic significance. A taxpayer never had the right to reallocate debits and credits among related business entities to effect tax economy. It is still not possessed with this right as a result of this decision. The Commissioner always had a right to do so to prevent tax evasion or clearly to reflect income. Now the Commissioner as a result of this decision may consolidate all the income of several related businesses into one entity even though only as little as 10%, 20% or 30% or any small fraction of an entity's income had been misallocated, whereas formerly he could reallocate only the misapplied income. This decision therefore is not only inequitable but unwarrantedly penal in nature.

Section 718, Credit for Excess Profits Taxes.

We have seen that the Second Circuit Court finds ample justification in the facts at bar to pierce two corporate entities and to destroy economically a sole proprietorship and to telescope all this income into the petitioner-corporation. As a consequence, the latter has to pay federal income and excess profits taxes on their aggregate incomes, though there was only an alleged partial misallocation of income. Strange to relate, however, to compute its swollen excess profits tax, it is denied the right to treat the invested capitals of the four entities as if they belonged to it. Certainly, these aggregate earnings subject to income and excess profits taxes must have arisen from the joint capital investments. This irrational inconsistency renders this part of the decision particularly arbitrary and inequitable.

The Second Circuit Court in the last paragraph of its decision says as to this issue in part:

> "The petitioner might be right if the other enterprises were mere shams, but they were used for business purposes and their business activity must be recognized in computing the equity invested capital credit. This is consistent with the manner in which Section 45 is applicable; the reallocation of income thereunder being based not on a disregard of taxable entities but on the correction of business entries."

The petitioner submits that this extract is a model of tax confusion. If the four entities are admittedly not shams but separate and distinct business enterprises for income tax purposes, then in the language of Section 45,

> "the Commissioner is authorized to redistribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses."

In the instant case, the Second Circuit Court telescoped the incomes of all the four entities into the petitioner. This could only be justified in the light of this Court's own thinking if the other three entities were shams, or if all were charged with civil or criminal tax fraud. As for their being shams, the petitioner agrees with the Second Circuit Court that they were not. And as for their being charged with tax fraud, there is no evidence of that as reflected in the fact that no attempt has been

made to assess them with criminal or civil fraud penalties, not even negligence penalties.

Despite its denial, the Second Circuit Court has treated three of the entities as shams for income tax purposes as evidenced by its actual conduct. It even destroyed economically the prime mover of the four ventures—a human being sole proprietor. Consequently, it is only rational and consistent to treat them as shams for excess profits tax purposes.

The Second Circuit Court declares in the same last paragraph of its decision in the instant case that it is denied the right to telescope the invested capitals of the four entities for excess profits tax purposes under Section 718 I. R. C., 26 U. S. C. 718 because:

> "the definition (under Section 718 of equity invested capital) does not include money or property paid into some corporation other than the taxpayer claiming the credit, and certainly does not include the net worth of an individual." (Words in parentheses supplied.)

The Second Circuit Court had no qualms about piercing two corporate entities. It did not hestitate to wipe out economically a human being who operated the sole proprietorship and was the prime mover in all four enterprises. Yet it accords Section 718 so much respect that it cannot telescope the invested capitals of the four entities though it places the Second Circuit Court in the illogical position of saying that the four entities have their own separate and distinct capital investments but the earnings therefrom for income tax purposes all belong to the petitioner. (Of course, sole proprietorships pay no excess profits taxes.)

Because of the novelty of the decision of the Second Circuit Court as to the invested capital issue, there is no

reported case in point, which makes this decision particularly arbitrary. However, the petitioner would like to bring to this Court's attention *P. Dougherty Co.*, 5 T. C. 791, affirmed (C. C. A.-4; 1946), 159 F(2d) 269, 35 A. F. T. R. 669, cert. den. June 2, 1947. This case involved a situation in which a corporate-taxpayer was organized with assets having a value of $250,000 for capital stock of $30,000 and for paid-in capital of $220,000. The Commissioner's efforts to restrict this taxpayer's invested capital for excess profits tax purposes under Section 718 to $30,000 were defeated by the courts which held that the taxpayer's credit under Section 718 was based on the $250,000 investment. By the same token, it appears to the petitioner that the invested capital of all four entities should be attributed to it for excess profits tax determination if all their respective incomes are to be allocated to it for excess profit as well as income tax purposes.

Petitioner's Contention.

The business entities involved in this tax controversy are:

	Referred To As
Advance Machinery Exchange, Inc.	Petitioner Advance
Awon Holding Corporation	Awon
Blachman Machinery Co., Inc.	Blachman, Inc.
Joseph Blachman	J. Blachman

A. The Four Enterprises Are Separate and Distinct Business Entities.

The petitioner urges that the decision of the Second Circuit Court is clearly erroneous in fact as well as in

law, and is therefore arbitrary and unreasonable. Neither Section 22(a) nor Section 45 enables the Second Circuit Court to bunch the net incomes of the four entities into the petitioner. The petitioner holds that the Second Circuit Court in the instant case should have reversed the conclusions of fact of the Tax Court and found that:

(1) there was a logical and natural division of the businesses carried on by the four entities based on the facts in the Transcript of Record of the Tax Court, and

(2) there was a sound, distinct and legitimate business purpose for each entity.

It is not the purpose of this Petition and Brief for a Writ of Certiorari to prove these conclusions of fact. This will be done, it is hoped, when it is granted. Suffice it to say at this time that the petitioner challenges the validity of the conclusions of fact as it has already done as to law, and if given the opportunity, it will be able to establish that none of the four entities were shams.

B. In the Alternate, Joseph Blachman and Seymour Blachman, Not the Petitioner, Should Be Held Accountable for the Earnings of the Four Entities.

As an alternative, the petitioner contends that if the tax-separability of the four entities is not upheld, then their aggregate incomes should be allocated to Joseph Blachman and Seymour Blachman on the theory that they were the real earners of the income.

The Second Circuit Court replied to this proposition by saying that since Joseph Blachman and Seymour Blachman chose to employ a corporate entity i.e., the petitioner, to do business it must accept its tax disadvantages, citing *Higgins* v. *Smith*, 308 U. S. 473.

The petitioner raises no objections to this but contends that all four businesses are distinct and separate taxable entities with their own respective advantages and disadvantages and wants them so recognized. It does not believe that it is no more or less sham than the other two corporations or particularly the sole proprietor. It argues, in the alternative only, that if these four entities are not respected as such for tax purposes that their earnings should be attributed to Joseph Blachman and Seymour Blachman as the true earners of said income. For that purpose, it is established tax law that the four entities may properly be ignored.

Com'r v. *Laughton,* 113 F. (2d) 103 (C. C. A.-9);
Griffiths v. *Helvering,* 308 U. S. 355;
Hyman v. *Nunan,* 143 F. (2d) 425 (C. C. A.-2);
Hoag v. *Com'r,* 101 F. (2d) 948 (C. C. A.-10);
Anderson, 5 T. C. 443, affirmed 164 F. (2d) 870 (C. C. A.-7);
Overton, 6 T. C. 304;
Blair v. *Com'r,* 300 U. S. 5;
Lucas v. *Earl,* 281 U. S. 111;
Burnet v. *Leininger,* 285 U. S. 136.

The petitioner repeats in the alternative that the incomes of the four entities be attributed to Joseph Blachman and Seymour Blachman as the true earners of said income. This conclusion is very sound in the light of the evidence and testimony.

Our authority for this contention is the Tax Court itself, which the Second Circuit Court affirms. In its opinion in the case at bar, it says as follows:

> "All four businesses were controlled by J. Blachman and Seymour Blachman, father and son. The two operated the business and kept the books and records of all four businesses in such a way that the

net profit of each could be manipulated as they saw fit, and, in general, so conducted the business that it is impossible to determine where the activities of one or the other begin and end" (Tr. 131).

Again using the Tax Court opinion, which the Second Circuit Court affirms, as authority, we say Joseph Blachman and Seymour Blachman were the actual earners of the aggregate net incomes of the four entities. We quote the language of the Tax Court:

> "All the stockholders were members of the immediate family of J. Blachman and received their shares of stock as gifts from him" (Tr. 105).

As further evidence that Joseph Blachman and Seymour Blachman in the instant case were the real earners of the aggregate incomes of the four entities, we quote further from the Tax Court's conclusions:

> "J. Blachman has been president of petitioner (Advance) and of Awon and treasurer of Blachman Inc. continuously since the formation of those corporations" (Tr. 107).
>
> "Seymour Blachman has been president of Blachman Inc., and secretary and treasurer of Awon since their incorporation. He has been vice-president of petitioner since about 1936" (Tr. 107).
>
> "J. Blachman and Seymour Blachman did most of the buying and part of the selling of petitioner, Blachman Inc., Awon and J. Blachman, individually" (Tr. 107).
>
> "In many cases a single purchase invoice included numerous articles of machinery, particularly where the invoice represented a purchase at an auction sale or the purchase of an entire plant. Subse-

quent to the purchase, the various items were marked as the property of one of the four business entities herein involved as J. Blachman or Seymour Blachman saw fit. There was no set policy in this regard" (Tr. 124).

"The books and records of petitioner as well as those of Blachman Inc., Awon, and J. Blachman were kept in such a way that net profits could be and were shifted from one to the other as J. Blachman and Seymour Blachman saw fit" (Tr. 125).

In the opening statement to the Tax Court in the case at bar, the respondent himself made the following admission when referring to the four entities:

"In form, they have separate corporations. In form they kept separate books and records, but, in substance, it was one business, conducted at one place of business, with the same employees, the same men, Mr. Joseph Blachman and Mr. Seymour Blachman, managing the business. They dealt with the same type of machinery and they shifted business between themselves as they saw fit, from one to another, before they would sell to the customer.

"In other words, Mr. Blachman, Sr. and Mr. Blachman, Jr. could control the amount of profit that would be reflected on the books of any of the four entities" (Tr. 185, 186).

In sum, in the alternate, we take the Tax Court at its word, i.e., the true earners of the income of the four entities in 1942 were Joseph Blachman and Seymour Blachman and not Advance. Consequently, let us attribute to these two men the earnings of the four entities. In the spirit of *Lucas* v. *Earl*, 281 U. S. 111 (1930), let us allocate the aggregate profits to the tree on which they grew.

Questions Presented.

A taxpayer never had the right under Section 45 to reallocate debits and credits among several business entities for any reason including the effectuation of tax economy. The Second Circuit Court's decision in the instant case still denies taxpayers this right. On the other hand, the Commissioner of Internal Revenue, and only he, had this right to prevent tax evasion or clearly to reflect the incomes of the several business entities in a group. The decision of the Second Circuit Court in the instant case permits him now to *penalize* a tax payer under similar circumstances by dumping all the incomes without discrimination of related business entities into it even though there is only a partial reallocation, no matter how small, of debits and credits among them.

This decision is the first one under Section 45 which permits the Commissioner to telescope the incomes of several related businesses under these circumstances. It is very ominous and threatening. Tax practitioners and businessmen throughout the country are very much concerned about it. At best, taxpayers are at the mercy of the judgment of the Commissioner as to whether their intercompany transactions are at arm's length. It is one thing to permit him to reallocate those interrelated debits and credits to prevent tax evasion or clearly to reflect their respective entity incomes. It is quite another thing to allow him to penalize taxpayers by the indiscriminate consolidation of total entity incomes.

The specific questions raised by this decision are:

1. May Section 45 of the Internal Revenue Code in the instant case be treated as a penal measure so as to permit the telescoping of all the incomes of four business entities (three corporations and a sole proprietorship)

into one of them, the corporate-petitioner, when the obvious construction of this statute would permit at the worst only a reallocation of those debits and credits necessary to reflect correct respective entity incomes?

The Second Circuit Court decided this issue in the affirmative in the instant case, *Advance Machinery Exchange, Inc.* v. *Commissioner,* No. 83, May 12, 1952 (52-1 U. S. T. C. Para. 66,036), which affirmed the Memorandum Decision of the Tax Court of the United States, 8 T. C. M. 84, C. C. H. Dec. 16,812 (M). On the other hand, the Third Circuit Court in *Chelsea Products* (C. C. A.-3, Nos. 10652, 10653, June 24, 1952) refutes this contention in commenting on this very decision.

2. If the petitioner is chargeable with the aggregate incomes of all four entities for excess profits tax as well as income tax purposes under Section 45, may it not treat the invested capitals of all four entities as if they all belonged to it for purposes of the excess profits tax computation?

The Second Circuit Court decided in the negative. This part of the decision appears to the petitioner to be inconsistent, illogical and arbitrary.

3. Is the inanimate corporate-petitioner in substance the true earner of the incomes of the other two corporations and of the sole proprietorship as well as of its own?

The petitioner contends that the Second Circuit Court's decision is fallacious in fact and in law in holding that the incomes of the other two corporations and of the sole proprietorship belong to it. It urges that the Transcript of Record of the Tax Court amply establishes that the other two corporations had their own separate and distinct business identities and were no more or less shams than it was. It particularly finds incomprehensible the treatment accorded the sole proprietor who was destroyed

economically despite the fact that he is a human being and admittedly the prime mover in all four enterprises. *This sole proprietor organized a trucking business in 1914, a second-hand machinery business in 1923, and added new machinery in 1939, long before the excess profits tax law of 1940 of the Second World War.*

4. If two corporations and the sole proprietorships are shams and unreal, then is not the corporate-petitioner just as much sham and unreal with the consequence that the aggregate incomes of the four enterprises should be attributed to Joseph Blachman and Seymour Blachman,—the admitted prime movers of all the ventures?

The petitioner argues in the alternative that Joseph Blachman and Seymour Blachman are the true earners of the aggregate incomes of the four business entities, because if two of the three corporations in the group are shams they must all be so.

5. If the fact findings of the Tax Court and the Second Circuit Court are *arguendo* correct, then why should not this case in the alternate be remanded to the Tax Court to have it reallocate the debits and credits among the four entities to the extent found by the Revenue Agents to be misapplied to effect the correct tax reporting of the four respective entities?

The petitioner argues in the alternative that Section 45 is not a penal statute. If there has been a misallocation of debits and credits among the four entities then the Tax Court should be asked to reallocate such inaccurate debits and credits as found by the Revenue Agents to correct their respective incomes within the language and spirit of Section 45.

REASONS RELIED ON FOR THE ALLOWANCE OF WRIT.

1. The Second Circuit Court in the instant case rendered a decision in conflict with that of all the other Circuit Courts and the Supreme Court of the United States involving Section 45 of the Internal Revenue Code. This is the first decision in which an indiscriminate, telescoping of the total incomes of four business entities into a corporate member was effected by an erroneous judicial interpretation of a statute which obviously permits the Commissioner the right only to reallocate those debits and credits among related businesses to prevent tax evasion or clearly to reflect their respective incomes. One month after this decision, the Third Circuit Court in *Chelsea Products* (C. C. A.-3, Nos. 10652, 10653, June 24, 1952) took the opportunity to criticize this decision. The following are some of the leading decisions involving Section 45 which are in conflict with the decision in the instant case:

Moline Properties, Inc. v. *Com'r,* 319 U. S. 436;
Burnet v. *Clark,* 287 U. S. 410;
Burnet v. *Commonwealth Improv. Co.,* 287 U. S. 415;
National Carbide Corp. v. *Com'r,* 336 U. S. 422;
Ross v. *Com'r,* 129 F (2d) 310 (C. C. A.-5, 1942);
Miles-Conley Co., Inc. v. *Com'r,* 173 F (2d) 958 (C. C. A.-4, 1949);
John L. Denning & Co., 180 F (2d) 288 (C. C. A.-10, 1950);
Seminole Flavor Co., 4 T. C. 1215 (1945);
Buffalo Meter Co., 10 T. C. 83 (1948);
Twin Oaks Company v. *Com'r,* 183 F (2d) 385 (C. C. A.-9, 1950).

2. The instant decision is penal in nature, and was and may thereafter be exercised by only the Commissioner of Internal Revenue without due process of law in violation of the Federal Constitution. The citizen never had a right to reallocate debits and credits among related business

entities to effect tax or business economy under Section 45. This decision does not now give him this authority. Yet, the Commissioner of Internal Revenue has always had this right to prevent tax evasion or to effect correct taxable income among related entities. Now, the Commissioner may go so far as to telescope the total incomes of related businesses into one of them under such circumstances no matter how little the misallocation of debits and credits has been among them. This situation was never intended by Congress, is inequitable, and is penal in nature without due process of law.

3. **Businessmen and tax practitioners are much alarmed over the potentialities of the instant decision. It is bound to curtail the economic growth of the country.** The lurking danger that the Commissioner might attack taxpayers with this new interpretation of Section 45 is bound to frustrate our national economic expansion. The questions above presented are of public importance and involve issues of general law in the relations of the citizen and his Government in conjunction with principles of fundamental justice in the collection of taxes.

WHEREFORE your petitioner prays that a writ of certiorari be issued under the seal of this Court directed to the United States Court of Appeals for the Second Circuit to the end that this cause may be reviewed and determined by this Court.

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Petitioner,

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BRIEF IN SUPPORT OF PETITION.

Advance Machinery Exchange, Inc., 8 T. C. M. 84, C. C. H. Dec. 16, 812 (M);
Advance Machinery Exchange, Inc., No. 83, May 12, 1952 (52-1 U. S. T. C. Para. 66,036).

Jurisdiction.

The statutes under which jurisdiction is invoked are Title 28, United States Code Section, 1254 and 2101, and Title 26, United States Code, Section 1141.

Cases which propound the principle of granting writs where questions of public importance are involved are:

Magnum Import Company v. *De Spoturno Coty*, 262 U. S. 159;
National Labor Relations Board v. *Waterman S.S. Corporation*, 309 U. S. 206.

The reasons for granting a review on writ of certiorari in this case under Rule 38 are found under the caption

Reasons Relied On For The Allowance Of Writ on pages 20 and 21.

Statement of Case.

The case, so far as material to the consideration of this application, is stated in this petition on pages 2 to 19.

Specifications of Errors.

The errors which petitioner will urge if a writ of certiorari is granted, are that the Court of Appeals for the Second Circuit erred in:

1. Telescoping in a penal, inequitable and arbitrary fashion the incomes of the four entities involved in this controversy into one of them—the corporate petitioner—in violation of the expressed intent of Congress as recited in Section 45 of the Internal Revenue Code and in the Treasury's own pertinent regulations,

2. Denying the petitioner the right to treat the invested capitals of all the four entities as if they all belonged to it for the excess profits tax computation as long as it is held accountable for their aggregate excess profits as well as income taxes,

3. Denying the existence of all four entities involved in this controversy as separate and distinct business and tax entities,

4. Denying the fact that Joseph Blachman and Seymour Blachman are the true earners of the aggregate incomes of the four entities, should all the entities be considered sham and unreal, and

5. Failing to remand the instant case to the Tax Court with instructions to reallocate the misapplied debits and credits of the four entities to the extent found by the Revenue Agents so as to correct the respective entity incomes.

Conclusion.

It is consequently concluded that the aforementioned errors committed by the Second Circuit Court in the instant case are of such national and personal importance to render appropriate under the rules of this Court a review of the decision of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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August, 1952.

Appendix.

Internal Revenue Code:

"Sec. 22. Gross Income.

"(a) General Definitions.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends; securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income."

"Sec. 45. Allocation of Income and Deductions.

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute,

apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses."

Regulations 111:

"**Sec. 29.45-1.** Determination of the taxable net income of a controlled taxpayer.—(a) Definitions. —When used in this section—

"(1) The term 'organization' includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Internal Revenue Code or these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

"(2) The terms 'trade' or 'business' include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

"(3) The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form nor the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

"(4) The term 'controlled taxpayer' means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

"(5) The terms 'group' and 'group of controlled taxpayers' means the organizations, trades, or businesses owned or controlled by the same interests.

"(6) The term 'true net income' means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

"(b) Scope and purpose.—The purpose of Section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or any item or element affect-

ing net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

"Section 45 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

"Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. *It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under section 141.* (Emphasis supplied.)

"(c) Application.—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits or allowances. The authority to determine true net income extends

to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

"Sec. 141. Consolidated Returns.

(a) Privilege to File Consolidated Returns.—An affiliated group of corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under subsection (b) prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) Regulations.—The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income-and excess-profits-tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

"Sec. 718. Equity Invested Capital.

(a) Definition.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) Money paid in.—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) Property paid in.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(1) for determining earnings and profits;

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In the Supreme Court of the United States

OCTOBER TERM, 1952

No. 259

ADVANCE MACHINERY EXCHANGE, INC.,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW.

The findings of fact and opinion of the Tax Court (R. 33-48) are not officially reported. The opinion of the Court of Appeals (R. 336-341) is reported at 196 F. 2d 1006.

JURISDICTION.

The judgment of the Court of Appeals was entered on May 12, 1952. (R. 341-342.) The petition for a writ of certiorari was filed on August 6, 1952. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED.

The taxpayer corporation and two other entities —a corporation and a sole proprietorship—were all owned and controlled by the same interests and were all engaged in the same business. The taxpayer corporation carried on by far the greatest part of the business, and income earned by it was on a large scale diverted to and reported by the other entities. The books and records of all three entities were kept in such a way that it was impossible to determine where the activities of one or the other entity actually began and ended, and portions of these books and records were destroyed by taxpayer while this case was pending.

The questions are:

1. Whether the net income reported as that of the other entities was properly allocable to the taxpayer corporation under Sections 22(a) and 45 of the Internal Revenue Code; and

2. Whether, in arriving at the taxpayer corporation's excess profits credit based on its equity invested capital as defined in Section 718 of the Code, the equity invested capital and net worth of the other entities should be attributed to it.

STATUTES AND REGULATIONS INVOLVED.

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 17-21.

STATEMENT.

The Tax Court's findings (R. 34-43), which the Court of Appeals held to be amply supported by the evidence (R. 337-338), may be summarized as follows:

The taxpayer corporation is one of three organizations engaged in the second-hand machinery business, all of which are owned and controlled by Joseph and Seymour Blachman, father and son, and members of their immediate families. (R. 34-36.) [1]

During the year 1942 these three organizations and Awon were all dealing in the same kind of second-hand machinery and had many customers in common. (R. 42.) They all occupied the same offices at 193 Centre Street, New York City, and shared both employees and equipment. Joseph and Seymour Blachman handled most of the buying and part of the selling for all four organizations. (R. 36-37.)

The taxpayer corporation, which has been active since its incorporation in 1928,[2] carried on by

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[1] The other two organizations are Blachman Machinery Company, Inc. (called Blachman, Inc.), and the sole proprietorship of Joseph Blachman (called J. Blachman). The income of a fourth organization, Awon Holding Corporation (called Awon), was initially involved but was eliminated at the hearing, see fn. 4, *infra*, p. 6). A fifth organization, the Jay-Esa Machinery Company, a partnership of Joseph and Seymour Blachman, is not here involved. (R. 37.)

[2] The taxpayer corporation was organized in 1928 by Joseph Blachman to carry on the second-hand machinery business which he had previously conducted as a sole proprietorship. (R. 37-38.) Blachman, Inc., began business in 1930; however, it became dormant in 1933 or 1934, and although not

far the largest part of the business. (R. 38, 39-41.) The name on the office door at 193 Centre Street was that of the taxpayer corporation, as was the principal name on a large window facing Centre Street. On the lower lefthand corner of the window, in rather small letters, were the names: "J. Blachman, Awon Holding Corporation, Blachman Machinery Corporation." The taxpayer corporation was a member of the Machinery Dealers National Association; the other three organizations were not. Awon was not listed in the Manhattan telephone book or classified directory as a dealer in machinery. Blachman, Inc., was not licensed as a dealer in second-hand machinery after the year 1934. (R. 36-37, 45.)

Separate net income was reported for each of the organizations for 1942. (R. 39-41.) Subsequently the books and records of these organizations were examined by an Internal Revenue Agent. He discovered that there had been numerous transactions where customers purchased machinery and paid the taxpayer corporation, although on the books and records the sales appeared to have been those of either Blachman, Inc., or Awon. He found that approximately 50 per cent of the purchase invoices of Blachman, Inc., which he examined (he examined at least half of all such invoices (R. 318)) had been altered. A large per-

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dissolved, did not become active again until 1942. (R. 36.) Joseph Blachman resumed his individual transactions in machinery in 1939. Awon was formed in 1941. (R. 34, 38.) Although Awon appears to have been organized to handle transactions different from those handled by the other three organizations, it did not actually do so. (R. 38.)

centage of the purchase invoices of Awon had also been altered. In the majority of these cases the purchase invoices had originally been made out to the taxpayer corporation, and in some instances, to J. Blachman. In many cases a single purchase invoice included numerous articles of machinery, particularly where the invoice represented a purchase at an auction or the purchase of an entire plant. Subsequent to such purchases the various items were marked as the property of one of the four organizations as Joseph Blachman or Seymour Blachman saw fit. There was no set policy in this regard. On some occasions this treatment of purchased articles was also applied to the proceeds of sales. Thus, there were 26 transactions where, upon the sale of machinery to customers, the taxpayer corporation collected the proceeds and then distributed all or a part of such proceeds to one of the other three organizations. (R. 15, 41-42.)

The social security returns of Blachman, Inc., indicate that it had no employees for the last half of 1942.[3] However, according to the sales invoice book of that company, it had 47 separate sales transactions after July 1, 1942, some of which included more than one item. The delivery and bookkeeping work on these sales was actually done by employees of the taxpayer corporation. (R. 37.)

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[3] The social security returns of Blachman, Inc., for the first and second quarters of 1942 list Seymour Blachman as the only employee of that company. The return for the third quarter lists no employees, and a statement is made thereon: "This corporation is inactive at the present time. However, it is not being dissolved at this time." No return was filed for the fourth quarter of 1942. (R. 37.)

The books and records of all four organizations were kept in such a way that net profits could be and were shifted from one to the other as Joseph and Seymour Blachman saw fit. In the year 1942 there were hundreds of transactions on the books where this was done. As a result it became impossible to determine where the activities of one or the other began and ended. (R. 42, 44.)

Various books and records of the business, although subpoenaed, were not produced at the trial. They had been thrown away in December, 1947, while this case was pending, by an employee of the taxpayer corporation upon orders of its bookkeeper. (R. 42, 45-46.)

The Commissioner of Internal Revenue assessed deficiencies in the taxpayer corporation's declared value excess profits tax and excess profits tax for the year 1942. These deficiencies were based upon his determinations (1) that the net profits reported for all four organizations [4] constituted taxable income to the taxpayer corporation within the purview of Sections 22 (a) and 45 of the Internal Revenue Code, and (2) that, in arriving at the taxpayer corporation's excess profits credit based upon its equity invested capital, as defined in Section 718, the invested capital of Blachman, Inc., and the personal capital of J. Blachman should not be included. (R. 14, 47.) Both of these determinations were sustained by the Tax Court (R. 43-48) and by the Court of Appeals (R. 336-341).

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[4] It was stipulated at the hearing that, for reasons not here relevant, the net profits reported as those of Awon would be withdrawn from such computation. (R. 43.)

ARGUMENT.

Section 22(a) of the Internal Revenue Code (Appendix, *infra,* p. 17) defines gross income in sweeping terms and requires that income be taxed to the individual or corporation which actually earns it. *Commissioner* v. *Sunnen,* 333 U. S. 591; *Helvering* v. *Clifford,* 309 U. S. 331. Section 45 (Appendix, *infra,* pp. 17-18) provides that:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The main question in this case—whether the Commissioner under these sections properly allocated to the taxpayer corporation the net income reported as that of Blachman, Inc. and J. Blachman [5] —is, as the court below observed (R. 337), "essentially one of fact," and taxpayer expressly asserts (Pet. 12-13) that it seeks review of the concurrent

[5] Of course, the taxpayer corporation cannot complain of the allocation to it of the net income which it reported as its own. The net income reported as that of the fourth organization, Awon, is no longer involved. See fn. 4, *supra.*

factual conclusions of the two lower courts. We submit that the record fully sustains the decision below; that taxpayer errs in its assertion of a conflict requiring review with *Commissioner* v. *Chelsea Products,* 197 F. 2d 620, where, on facts sharply different from those involved here, the Tax Court and the Court of Appeals for the Third Circuit agreed that allocation of income was improper; and that the petition should, accordingly, be denied.

a. In attacking the allocation in this case, the taxpayer corporation contends that the Court of Appeals treated the other organizations as shams (Pet. 11) and consolidated their net incomes with that of the taxpayer (Pet. 7). This contention embodies two erroneous assumptions—(1) that the Court of Appeals did not recognize the separate identities of the other organizations, and (2) that the other organizations had separate net incomes which could be consolidated. Actually, the Court of Appeals recognized the separate identities of the other organizations. It found, however, as the Tax Court had found, that the net income reported as theirs had in fact been earned by, and was therefore properly attributable to, the taxpayer corporation. Thus, the court stated (R. 338):

> Here, it was determined that there were four such entities but that only one, in fact, earned the income which was divided among all four and that one was the petitioner. Consequently,

it is the taxpayer to whom the income in question was properly allocated.[6]

Section 22(a) of the Code (Appendix, *infra*, p. 17), in defining gross income, implicitly requires that such income be attributed to the taxpayer who earns it, regardless of how the income may be reported. When the Commissioner attributed to the taxpayer corporation the net income reported as that of J. Blachman and Blachman, Inc., he determined that the taxpayer corporation was the true earner of that income. This determination, approved by both courts below, was presumptively correct, and the taxpayer failed to sustain its burden of proving otherwise.

There is nothing in the record of this case which supplies the clear and convincing evidence required to sustain petitioner's burden of proof with respect to the net income reported as that of J. Blachman. Refuting the taxpayer's undocumented assertion that the Commissioner and the courts below erred on this aspect of the case are the critical facts that (1) the distinction between purchases and sales by a closely-held corporation and purchases and sales by its principal stockholder-officer is particularly shadowy and artificial, and (2) J. Blachman, having concededly acted only as

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[6] In its opinion the Tax Court also refers to "these four entities" (R. 45.) In the course of its discussion of the income earned by the taxpayer corporation and diverted to the other three organizations, the Tax Court later states that there was "but one taxable entity" (R. 46). By this statement, when read in context, it would appear that the Tax Court merely meant that there was but one taxable entity insofar as such income is concerned.

agent for the taxpayer corporation in carrying on the business from 1928 to 1939, had thereafter continued as the corporation's president. Cf. *Moline Properties* v. *Commissioner,* 319 U. S. 436. Similarly, the evidence with respect to the net income reported as that of Blachman, Inc., shows that this income was not actually earned by Blachman, Inc. The majority of the purchase invoices of Blachman, Inc., examined by the Internal Revenue Agent had originally been made out in the name of the taxpayer corporation and then altered. Even more significantly, Blachman, Inc., admittedly had no employees during the last half of 1942 when 47 of the transactions occurred from which its reported net income was supposed to have been earned. We submit, in short, that, on this record, which showed that the taxpayer corporation was in substantial fact the business enterprise to which the net income in question had accrued (R. 45, 338), the Tax Court was clearly correct in concluding that this income was properly attributable to the taxpayer under Section 22(a) of the Code.

In affirming the decision of the Tax Court, the Court of Appeals held that it was not necessary to rely on Section 22(a) alone, and emphasized the applicability of Section 45 (Appendix, *infra,* pp. 17-18). The latter section authorizes the Commissioner to allocate gross income or deductions between or among organizations owned or controlled directly or indirectly by the same interests where he determines that such allocation "is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations * * *". The section was designed to prevent tax evasion by any arbitrary shifting of income among

such organizations. *Asiatic Petroleum Co.* v. *Commissioner,* 79 F. 2d 234 (C. A. 2), certiorari denied, 296 U. S. 645, rehearing denied, 296 U. S. 664; *National Securities Corp.* v. *Commissioner,* 137 F. 2d 600 (C. A. 3), certiorari denied, 320 U. S. 794. Here, the reporting of net income actually earned by the taxpayer corporation as that of the other organizations was clearly such an arbitrary shifting of income. Moreover, the Tax Court specifically found (R. 42) that the books and records of the taxpayer corporation and the other organizations were kept in such a way that net profits could be and were shifted from one to the other as Joseph and Seymour Blachman saw fit. On these facts, the Court of Appeals correctly held that Section 45 furnished additional authority for the action taken by the Commissioner.

Nor is the propriety of this conclusion affected by the fact that, in order to prevent evasion in the circumstances of this case, it was necessary to tax to the taxpayer corporation alone all of the net income which had been reported as that of the three entities. For, as the Court of Appeals pointed out (R. 339), it would be absurd to interpret the policing provisions of Section 45 as permitting the Commissioner to reallocate only where some but not all of the income reported by various organizations was shifted; under such an interpretation, "tax evasion could be so complete as to make itself invulnerable."[7]

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[7] While Section 45 literally authorizes allocation of only gross income or deductions among controlled organizations, it is apparent that where all of the net income reported as that of one such organization is allocated to another, the alloca-

b. Contrary to petitioner's suggestion (Pet. 2-3, 8) that they are in conflict, the instant decision and the recent decision in *Commissioner* v. *Chelsea Products,* 197 F. 2d 620 (C. A. 3), are sharply distinguishable from each other on their facts, as is evidenced by the differing findings of the Tax Court and the opinions of the two Courts of Appeals. In *Chelsea Products,* both the Tax Court and the Third Circuit found that the separate entities there involved had actually performed distinct business functions and had accurately kept accounts of the income earned in performing such functions. On those facts the Tax Court found, and the Court of Appeals agreed, that Section 45, as shown by Treasury Regulations 111, Section 29.45-1(b) (Appendix, *infra,* pp. 20-21), did not authorize the Commissioner's consolidation of the net incomes actually earned by, and therefore properly attributable to, the separate entities. In

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tion is in effect one of gross income. Thus, where all of the net income reported by organization A is allocated to organization B, this is in reality either an allocation of all the gross income and all the deductions reported by A or an allocation of only that portion of the gross income reported by A which exceeds its deductions. In any event, the present taxpayer is scarcely in a position to complain of the accuracy of the allocation in this case or to suggest (Pet. 7, 19, 24) that the cause should perhaps be remanded to the Tax Court for a reallocation to the limited extent of specific misapplications found by the Internal Revenue Agents. For the record shows (see p. 6, *supra*) that (1) as a result of the book keeping practices employed, it is impossible to separate the activities of one organization from the other and (2) full examination of the relevant books and records was precluded after a portion of them was destroyed by taxpayer corporation during the pendency of this action.

the instant case, on the other hand, the Tax Court found that the separate entities performed no distinct or distinguishable functions, that they kept no accurate accounts, and that the taxpayer actually earned the net income reported as that of the other organizations so that the others in fact had no separate net incomes to consolidate. In these crucially different circumstances, the concurrent conclusions of the courts below are plainly consistent with the result in the *Chelsea Products* case.[8]

The two cases are distinguishable in still other respects. In *Chelsea Products,* the Commissioner did not state in his deficiency notice that his action was being taken pursuant to Section 45, and the petitions and answers raised no issue with respect to the application of that section. For this reason, the Third Circuit was of the opinion that the tax-

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[8] In its *Chelsea Products* opinion (197 F. 2d at 623, n. 6), the Third Circuit comments on the instant decision, emphasizing the factual distinctions we have noted. Its comments are to the effect, not that Section 45 should not have been applied to the facts here presented, but rather that, since the Tax Court had properly sustained the Commissioner under Section 22(a), it was unnecessary for the court below to rely on Section 45 in reaching its decision to affirm. This comment and the difference in the approaches of the two courts are hardly sufficient, in the light of the different facts of the two cases, to establish such a conflict as to require resolution by this Court.

The Government does not contemplate at this time the filing of a petition for a writ of certiorari in the *Chelsea Products* case, which was decided on June 24, 1952. We intend, however, to apply in that case for an extension of the time within which to petition for certiorari so that, in the event the instant petition is granted, our decision not to seek review can be reconsidered.

payer there could not be expected to shoulder its burden of proving the Commissioner's action arbitrary. Here, however, the taxpayer was apprised that the Commissioner was acting pursuant to Section 45 as well as Section 22(a) (R. 14). And since this taxpayer and the other organizations involved kept their books and records in a manner that made it impossible to determine where the activities of any one began or ended, the taxpayer has no basis, as the taxpayer in *Chelsea Products* may have had, for complaining that the Commissioner should have been more specific in his reasons for reallocating the income reported as that of the other organizations.

In short, the widely dissimilar facts of the two cases, particularly in light of the factual nature of the issue involved, refute the taxpayer's assertion of a conflict with *Chelsea Products*. Even more clearly erroneous is the contention that the decision below is contrary to a list of other cases the taxpayer cites (Pet. 20). Those cases involved merely the recognition of separate business entities with separate incomes where they carried on their own distinct functions and accurately kept separate accounts of the income earned from carrying on such functions. None of them involved the two crucial factors present here—(1) a large-scale diversion of the income earned by one entity to other entities, all of the entities being owned and controlled by the same interests, and (2) bookkeeping practices which made it impossible to determine where the activities of one or the other entity began and ended, coupled with a partial destruction of those books and records by the taxpayer corporation during the pendency of the action.

c. The taxpayer corporation argues (Pet. 13-16) that if the income separately reported as that of the three organizations is not to be taxed as reported, it should be treated as income, not of the taxpayer corporation, but of Joseph and Seymour Blachman, on the theory that they were the real earners of that income. This contention was sufficiently answered by the Court of Appeals as follows (R. 338):

> It was not these two individuals who, in fact, earned all of the income reported by the four enterprises any more than that would be true of the income of any closely held corporation. An individual "is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages." *Higgins* v. *Smith,* 308 U. S. 473, 477.

2. The taxpayer's remaining contention (Pet. 9-12, 23) is that if the net income reported as that of the two other organizations is to be allocated to it, then, in arriving at its excess profits credit based on its equity invested capital, the equity invested capital of Blachman, Inc., and the net worth of J. Blachman should likewise be allocated to it.

As defined in Section 718 of the Code (Appendix, *infra,* p. 18), equity invested capital is the sum of the money and property paid into the taxpayer corporation. It includes neither (1) money or property paid into some other corporation nor (2) the net worth of an individual. In contending for the inclusion of these latter items, the taxpayer here misreads the definition. Arguing that

money and property which had not been paid in should be treated as though it had been paid in, the taxpayer merely reasserts here its erroneous premise that the allocation of income to the taxpayer corporation entailed denying the corporate existence of Blachman, Inc., and the economic existence of J. Blachman, "a human being sole proprietor" (Pet. 11). As we have shown, however (*supra*, pp. 8-9), the allocation to the taxpayer rests, not on a denial of the existence of the other entities, but on the simple and determinative facts that the taxpayer corporation actually earned the income in question and diverted it to the other organizations. Properly rejected below, and admittedly presenting no conflict with any other decision (Pet. 11-12), the argument under Section 718 is no ground for review by this Court.

CONCLUSION.

The decision below is correct. There is no conflict in the decisions. No other reasons appear which would warrant further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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SEPTEMBER, 1952.

APPENDIX.

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to re-

flect the income of any of such organizations, trades, or businesses.

(26 U. S. C. 1946 ed., Sec. 45.)

SEC. 718. [As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 982]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.45-1. DETERMINATION OF THE TAXABLE NET INCOME OF A CONTROLLED TAXPAYER.—(a) *Definitions.*—When used in this section—

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in

the Internal Revenue Code or these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at

arm's length. It does not mean the income, the deductions, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and Purpose.*—The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, or any item of either, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

*U. S. Government Printing Office—1952—221916/P. O. 332